No. 11,168

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

PARROTT & COMPANY (a corporation),
Appellant,

vs.

UNITED STATES OF AMERICA,
Appellee.

On Appeal from the District Court of the United States for the Northern District of California.

BRIEF FOR THE UNITED STATES.

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BRIEF FOR THE UNITED STATES.

OPINION BELOW.

No previous opinion in this case has been rendered.

JURISDICTION.

This appeal involves federal distilled spirits taxes. The taxes in dispute, totaling $9,606.32, were paid on various dates from December 8, 1938, to October 29, 1941. (R. 16-18.) Claim for refund was filed on December 3, 1942 (R. 8), was rejected by notice dated September 16, 1943, thereafter was reconsidered on protest of claimant, and again rejected on October 6, 1943. (R. 9.) Within the time provided in Section

3772 of the Internal Revenue Code and on January 10, 1945, the taxpayer brought an action in the District Court for recovery of the taxes paid. (R. 2-14.) Jurisdiction was conferred on the District Court by Section 24, Twentieth, of the Judicial Code. Motion to dismiss was filed March 24, 1945, and an order granting the motion was filed July 20, 1945. (R. 19.) Within three months and on September 4, 1945, a notice of appeal was filed (R. 20), pursuant to the provisions of Section 128 (a) of the Judicial Code, as amended.

QUESTIONS PRESENTED.

1. Whether rum brought into the United States from the Virgin Islands is taxable under Section 600 of the Revenue Act of 1918, as amended, and Section 2800 of the Internal Revenue Code at a rate equal to the tax on like articles manufactured in the United States or at the rate imposed upon like articles imported from foreign countries.

2. Whether the rum was taxable under Section 600 of the Revenue Act of 1918, as amended, and Section 2800 (a) (5) of the Internal Revenue Code as a rectified product.

3. Whether the basic tax imposed on distilled spirits under Section 600 of the Revenue Act of 1918, as amended, and Section 2800 (a) (1) of the Internal Revenue Code was collectible on the wine gallons where at the time it is withdrawn from the customs warehouse the rum was 86 proof.

STATUTES AND OTHER AUTHORITIES INVOLVED.

The pertinent statutes and other authorities herein referred to will be found in the Appendix, *infra,* pages i-xi.

STATEMENT.

This is a suit brought by the taxpayer seeking a refund of internal revenue taxes paid on distilled spirits which were brought into the United States from the Virgin Islands during the years 1938 to 1941. The Government filed a motion to dismiss on the grounds that the facts alleged in the complaint failed to state a cause of action, and the complaint shows upon its face that all taxes paid were legally and properly collected from the taxpayer. The Court below dismissed the complaint (R. 19), and the taxpayer has appealed from that order.

The complaint herein filed sets forth in detail Formulae 2, 7, 10, 11, and 12, in accordance with which the taxed rum was produced. Under each of the formulae the rum was mixed with some coloring matter or flavoring material, or blended with another kind of rum, as clearly appears from the formulae as alleged in paragraph V of the complaint. (R. 5-8.) The rates of taxes and the amounts collected are also a part of the complaint. (R. 14-18.)

Under some of the formulae the rum was distilled in a continuous column still at less than 190 proof, and some of the spirits were placed in charred oak

barrels for aging, and other of the same spirits were placed in reused barrels at over 100 degrees proof. After aging, these two spirits are mixed and the resultant product was reduced with distilled water to 86 proof after which it was filtered and bottled.

SUMMARY OF ARGUMENT.

Rum brought into the United States from the Virgin Islands is subject to taxes in a sum equal to the taxes payable on like articles manufactured in the United States, as provided by Section 3350 (a) of the Internal Revenue Code. This is the policy with respect to all insular possessions and it is not affected by any trade agreements with other countries. The rum in question was subject, as provided in Section 2800, Internal Revenue Code, as amended, to the rectifying tax of 30 cents per proof gallon and the basic distilled spirits tax of $2.25, $3 and $4, the rate in effect at the time the rum was withdrawn from the warehouse. The rectifying tax applies because the spirits became spurious, imitation or compound liquors when mixed with the other materials described in the formulae. The proof gallon rate is never applicable where, as here, the rum was below proof when withdrawn.

ARGUMENT.

I.

RUM BROUGHT INTO THE UNITED STATES FROM THE VIRGIN ISLANDS IS SUBJECT TO THE TAXES LEVIED BY SECTION 600 OF THE REVENUE ACT OF 1918, AS AMENDED, AND SECTION 2800 OF THE INTERNAL REVENUE CODE.

In determining the issues in this case we must bear in mind the intent of Congress to establish and maintain a parity in regard to taxation between manufacturers in the Virgin Islands and those in the United States. This intent prevails with regard to all our insular possessions, as is shown by the following:

Hawaii. All the laws of the United States which are not locally inapplicable, shall have the same force and effect within the said Territory as elsewhere in the United States. Act of April 30, 1900, c. 339, 31 Stat. 141, Sec. 5.

Upon articles imported from Puerto Rico there is imposed a tax equal to the internal revenue tax imposed in the United States upon the like articles of merchandise of domestic manufacture. Act of April 12, 1900, c. 191, 31 Stat. 77, Sec. 3.

Upon articles imported from the Philippine Islands there is imposed a tax equal to the internal revenue tax imposed in the United States upon the like articles, goods, wares or merchandise of domestic manufacture. Act of October 3, 1913, c. 16, 38 Stat. 114, 192, Sec. IV C.

Upon articles imported from the Virgin Islands there is imposed a tax equal to the internal revenue tax imposed in the United States upon like articles.

Revenue Act of 1917, c. 63, 40 Stat. 300, Sec. 1000*; Revenue Act of 1918, c. 18, 40 Stat. 1057, Sec. 1304.

The above citations show clearly the intent of Congress. All the laws of the United States not locally inapplicable have full force and effect in Hawaii. Because the laws of the United States are not applicable in the other island possessions a tax equal to the tax imposed upon like articles of domestic manufacture has been imposed upon imports from those islands by specific statutes, and the courts have so construed them. *Jordan v. Roche,* 228 U.S. 436; *United States v. Rathjen Bros.,* 137 F. (2d) 103; *Santoni & Co. v. Rafferty,* 10 F. (2d) 788 (C.C.A. 2d); *Bornn v. United States,* 61 C. Cls. 425, certiorari denied, 271 U.S. 684.

The provisions of Section 3 of the Virgin Islands Act of 1917 (Appendix, *infra*), that the taxes to be paid shall be rates required to be paid upon like articles imported from foreign countries are clearly in conflict, irreconcilable and inconsistent with the provisions of Section 1304 of the Revenue Act of 1918. The 1918 Act being the later is therefore controlling. *Posadas v. National City Bank,* 296 U.S. 497; *United States v. Chaflin,* 97 U.S. 546; *United States v. Tynen,* 11 Wall. 88; *United States v. Rathjen Bros., supra.*

The Liquor Tax Administration Act, Section 329 (c) (Appendix, *infra*), makes Title III of the National Prohibition Act, and the provisions of the in-

*For the legislative history see H. Rep. No. 45, 65th Cong., 1st Sess., p. 10 (1939—1 Cum. Bull. (Part 2) 48).

ternal revenue laws relating to enforcement, applicable in the Virgin Islands.

Section 2800 (a) (1) of the Internal Revenue Code (Appendix, *infra*), approved February 10, 1939, expressly levies the tax upon the distiller and importer, and paragraph (a) (5) imposes in addition thereto the 30 cents per gallon rectifying tax. Paragraph (a) (4) (B) refers to Section 3350, Internal Revenue Code (Appendix, *infra*), for provisions with reference to tax on alcohol products coming from the Virgin Islands.

Section 3350 provides for "a tax equal to the internal revenue tax imposed in the United States upon like articles of domestic manufacture."

Trade agreements with foreign countries have no application to the possessions of the United States (*De Lima v. Bidwell,* 182 U.S. 1) and, therefore, have no bearing on this case. In any event, the taxing statutes, increasing the taxes, which are subsequently passed by Congress supersede such trade agreements unless Congress expressly expects them. In *United States v. Rathjen Bros., supra,* the Court said (p. 105):

> When the Congress enacted the statute providing that all *distilled spirits imported into the United States* should be subject to an internal revenue tax of $2.25 per proof gallon it certainly must have intended to include imported rum regardless of the size of the containers and regardless of the country from which exported. If we were to hold that the involved merchandise is excepted

> from the said statute by reason of the quoted provision of the Cuban Trade Agreement of 1934, we would read an exception into the statute, thereby nullifying that portion of the act levying an internal revenue tax on *all distilled spirits imported into the United States.* (Italics supplied.)

The purpose of the enactment of Section 3350 (a) of the Internal Revenue Code was obviously to provide for the payment of taxes on articles brought into the United States from the Virgin Islands in a sum equal to the taxes on like articles manufactured in the United States. This construction is clearly demonstrated if paragraphs (a) and (b) of this section are read together, for paragraph (a) provides for the payment of a tax equal to that imposed upon a domestic manufacturer, and paragraph (b) exempts such articles from the tax imposed by the internal revenue laws of the Virgin Islands when such articles are imported into the United States. To hold otherwise would place distilled spirits brought in from the Virgin Islands in a preferred class and make it possible to sell such products at a cheaper price than domestic products of like nature.

The taxpayer is asking the Court to apply the Virgin Islands Act of March 3, 1917, and those provisions of the different trade agreements most favorable to it. These agreements do not support the taxpayer in the relief sought. Article XI of the Haiti Reciprocal Trade Agreement of March 28, 1935, 49 Stat. (Part 2) 3737, provides:

> Except as otherwise provided in the second paragraph of this Article, the provisions of this Agreement relating to the treatment to be accorded by the United States of America and the Republic of Haiti, respectively, to the commerce of the other country, shall not apply to * * * the Virgin Islands, * * *.

Article IV of the Agreement provides that the articles shall be exempt only from "all internal taxes * * * other or higher than those payable on like articles of national origin * * *. To the same effect is Article XIV of the Great Britain Reciprocal Trade Agreement of November 17, 1938, 54 Stat. (Part 2) 1897, 1903. Moreover, the Tariff Act of 1930, c. 497, 46 Stat. 590, Schedule 8, Par. 801 (b), provides:

> The duties prescribed in Schedule 8 and imposed by Title I shall be in addition to the internal revenue taxes imposed under existing law, *or any subsequent Act.* (Italics supplied.)

Since there is no language in any of the trade agreements which would modify this provision of the Tariff Act it appears that imported rum is subject to the internal revenue taxes. This construction is in conformity with the interpretation which the Supreme Court placed upon the Act of April 12, 1900, c. 191, 31 Stat. 77 (commonly called the Foraker Act), applicable to Puerto Rico, in *Jordan v. Roche, supra.*

Paragraph 802 of the Tariff Act provides for a duty of $5 per proof gallon which under the trade agreement with Great Britain has been reduced 50%,

thereby making the customs duty on distilled spirits $2.50 per proof gallon.

Under the Revenue Act of 1943, c. 63, 58 Stat. 26, Sec. 302, the tax on distilled spirits was increased to $9 per proof or wine gallon. If only $2 could now be collected on spirits imported from foreign countries, in addition to the payment of the duty of $2.50, the total amount of tax and duty on foreign spirits would be only $4.50 per gallon which would place the competitive rate at about one-half of the price of our local manufactured products. Today all importers are required to pay $9 per proof gallon, or $9 per wine gallon when below proof, on distilled spirits products imported from foreign countries. Thus the taxpayer's contention leads to a result which is quite inconsistent with the Congressional purpose.

It must be concluded, therefore, that the rum in question was subject to the same taxes as articles of like nature manufactured in the United States.

II.

THE RUM DESCRIBED IN THE COMPLAINT WAS SUBJECT TO THE RECTIFYING TAX OF THIRTY CENTS PER GALLON.

The rectifying tax is imposed by Section 2800 (a) (5), Internal Revenue Code, on the products of a manufacturer who is rectifier within the meaning of Section 3254, Internal Revenue Code. (Appendix, *infra.*) It makes no difference whether the manufacturer is regulated by our occupational tax laws or not,

the tax is nevertheless collectible on the article. The rectifying tax of 30 cents per gallon on the rum in question was properly and legally collected.

Products of rectification are defined in Section 2800 (a) (5), Internal Revenue Code, as "all distilled spirits or wines rectified, purified or refined in such manner, * * * that the person so rectifying, purifying, refining or mixing the same is a rectifier within the meaning of section 3254 (g): * * *". Section 3244 (g) of the Revised Statutes (which is the predecessor of Section 3254 (g)) was interpreted by the Circuit Court for the Middle District of Tennessee in *Michel v. Nunn,* 101 Fed. 423. That was an action against the Collector of Internal Revenue brought by the taxpayer to recover taxes exacted from the taxpayer as a rectifier of spirits where he had mixed whiskey with sugar and water and placed the resultant mixture in bottles on his shelf for sale. The Court emphasized the broadness of the statute by the use of the phrase "mixing with any material", as may be seen from the following quotation (p. 424):

> Rev. St. Sec. 3244, subd. 3. Now, the statute thus enumerates classes who are actually engaged in modes of refining or rectifying, and after having classified in this way, for the purpose of ascertaining when persons are subject to this tax, the statute passes entirely away from persons actually engaged in any process of distillation or refining, by saying, "and every person who without rectifying," going entirely away from those who have been purifying or refining, to the statement, "every person who without rectifying, purifying

> or refining distilled spirits." So there is here clearly the intent to include every person, the act passing to what may be called "compounding." Such persons are not rectifying, purifying, or refining, but compounding. "Shall by mixing such spirits, wine, or other liquor with any material," are the words of the statute; "with any material," not by mixing wines or liquors of one kind with another, but with "any material"; and thereby "manufacture any spurious, imitation, or compound liquors for sale, under the name of whiskey, brandy, gin, rum, wine, spirits, cordials, or wine bitters, or any other name, shall be regarded as a rectifier, and as being engaged in the business of rectifying." Now, it has not been asserted that that language, "by mixing the liquors with any material," has any technical or trade meaning, or that its meaning is other than in ordinary use, and, taking it in its ordinary use, in the popular sense, it certainly could not be said that, if it is mixed with either water or sugar or blackberry juice, it is not mixed with any material,—"any material." And it strikes me that an interpretation that would undertake to say that certain materials are within the statute, and other materials are not within it, when the statute itself uses the term "any material," would nullify the statute.

A similar broad interpretation was placed upon this statute by the District Court for the Southern District of New York in a forfeiture proceeding, *Quantity of Distilled Spirits,* 20 Fed. Cas. No. 107, where the Court construed the term "rectifier" with the following language (p. 108):

That the claimants were rectifiers of spirits is perfectly apparent. The eighteenth paragraph of the seventy-ninth section of the act of June 30th, 1864, as subsequently amended, defines what a rectifier is: "Every person, firm or corporation who rectifies, purifies, or refines distilled spirits or wines by any process, or who, by mixing distilled spirits or wines with any materials, manufactures any spurious, imitation or compound liquors for sale, under the name of whiskey, brandy, gin, rum, wine, spirits, or wine bitters, at any other name, shall be regarded as a rectifier." That is the definition the law gives of a rectifier. A rectifier is not merely a person who runs spirits through charcoal, but anyone who rectifies or purifies spirits in any manner whatever, or who makes any mixtures of spirits with anything else, and sells it under any name, is a rectifier.

Under Formula 2, aged rum made from sugar cane is withdrawn from charred oak barrels and "blended with white rum made from molasses". (R. 5.)

Under Formula 7, "7/10 of 1 percent of sugar caramel is added" to the rum. (R. 5.)

Under Formula 10, the rum made from molasses is placed into "newly charred oak barrels, and into reused oak barrels, from which all char has been removed, for ageing." After ageing, the rum from the "reused cooperage is mixed with rum from the new charred cooperage". (R. 6.)

Under Formula 11, the rum is treated with "Darco carbon in the proportion of 2.4 pounds Darco carbon per one hundred gallons of rum". (R. 7.)

Under Formula 12, the rum is treated with "Darco carbon in the proportion of 1.0 pound Darco carbon per one hundred gallons of rum". (R. 8.)

Applying the broad interpretation placed upon Section 3254 (g) in the cases above cited, there certainly can be no doubt that the rum made under Formulae 7, 11 and 12, which show a mixture with other substances, was rectified. Neither should there be any doubt that the rum made under Formulae 2 and 10 was rectified within the meaning of Section 3254 (g), unless it comes clearly within the exceptions as provided in Section 2801 (c) (1) of the Internal Revenue Code (Appendix, *infra*). This section provides that the tax shall not attach to the mixing and blending of wines,——

> * * * nor to blends made exclusively of two or more pure straight whiskies aged in wood for a period not less than four years and without the addition of coloring or flavoring matter or any other substance than pure water and if not reduced below ninety proof; * * *.

and then only when compounded under the immediate supervision of a revenue officer in accordance with the Treasury regulations.

The rums described by the formulae set out in the complaint, on which the 30 cents rectifying tax was paid, do not come within the exceptions provided in Section 2801 of the Internal Revenue Code. It is our contention that these explicit exceptions as set out in the statute support the broad interpretation which the Courts have placed upon Section 3254 (g).

Section 3254 (g), Internal Revenue Code, which defines a rectifier does not limit the definition to a person who rectifies, purifies or refines distilled spirits, but after so defining a rectifier the statute includes others by this language:

> * * * and every person who, without rectifying, purifying, or refining distilled spirits, shall, by mixing such spirits, wine, or other liquor with any material, manufacture any spurious, imitation, or compound liquors for sale, under the name of whiskey, brandy, gin, rum, wine, * * * or any other name, shall be regarded as a rectifier, * * *
>
> (26 U.S.C. 1940 ed., Sec. 3254.)

A rectified product under Section 2800 (a) (5) of the Internal Revenue Code is one which falls under the classification that will cause the manufacturer to "be regarded as a rectifier". In other words, the taxing statute is not limited to articles which are manufactured by "rectifiers" as such. The taxpayer's argument that the rum is not a rectified product within the meaning of the statute, because the taxpayer was not a resident rectifier, cannot be sustained.

In *Quantity of Distilled Spirits, supra,* the Court instructed the jury that under the evidence introduced at the trial the claimants were rectifiers. In arriving at this conclusion the Court quoted the statute and emphasized the broad language there used. In the case at bar the United States upon its motion to dismiss asked the District Court to rule that the rums manufactured under the formulae set out in the com-

plaint were rectified products within the meaning of the statute, and the lower Court has so held.

Under the wording of the statutes and their broad interpretation by the Courts, the rums in question were definitely rectified products and taxable as such. When distilled spirits are mixed "with any material" other than distilled water which is used in reducing the proof, the spirits become spurious, imitation, or compound liquors. The rums described in the complaint, having been mixed with other materials, as set out in the formulae, are clearly within the definition.

The taxpayer argues that the statutes relating to rectifiers within the United States have no application to it. This is true only with reference to the statutes which impose occupational taxes upon rectifiers. But no occupational taxes were collected from the taxpayer and none are involved in this suit. The rectifying tax of 30 cents per gallon here involved is an excise tax on the product, and is collectible regardless of whether the rum was produced by a licensed or an unlicensed rectifier. See *United States v. One Ford Coupe,* 272 U.S. 321, 328.

If the taxpayer's reasoning is accepted with respect to the statutes regarding rectifiers in the United States, then it may be said that the same reasoning should apply to distillers and, therefore, the basic production tax on distilled spirits brought into the United States is not collectible because the laws regulating distillers have no application to manufacturers outside the boundaries of the United States. Under

such anomalous reasoning, the United States has failed to tax distilled spirits brought into the United States from its possessions or even from foreign countries.

The taxpayer argues that prior to 1937, the rectifying tax was not collected by the Commissioner on distilled spirits brought from the Virgin Islands and for twenty-eight years the 1917 Act has been recognized as being applicable. By T. D. 4770, 1937—2 Cum. Bull. 568 (Appendix, *infra*), the Commissioner of Internal Revenue for the first time, by regulation, undertook to collect the rectifying taxes on distilled spirits brought in from the Virgin Islands.

In determining the time element the Court must keep in mind the fact that from 1919 to 1920 we had war prohibition in the United States (Sec. 1 of the Act of November 21, 1918, c. 212, 40 Stat. 1045), and from 1920 to December 5, 1933, we had national prohibition (National Prohibition Act, c. 85, 41 Stat. 305), and importation of distilled spirits from the Virgin Islands and foreign countries for beverage use was prohibited by Section 601 of the Revenue Act of 1918. (Appendix, *infra.*) During this fifteen-year period, therefore, it was unlawful to bring into the United States distilled spirits for beverage uses. The only importations permitted were for medicinal, food, and industrial uses. Very little, if any, rum was brought into the United States during that period, and the matter of considering the rectifying tax on such spirits was of little or no consequence.

The National Prohibition Act, and the supplemental Act of November 23, 1921, c. 134, 42 Stat. 222, were extended to the Virgin Islands by Section 3 of the latter Act.

In the Attorney General's Opinion of June 9, 1926, 35 Op. A.G. 63, cited by the taxpayer, only two questions were considered: Whether taxes could be collected in the Virgin Islands on the manufacture and sale of industrial alcohol which under the laws of the United States was tax exempt, and whether taxes collected in the United States on industrial alcohol produced in the Virgin Islands and brought into the United States should be covered into the Treasury of the United States. The taxing statutes were not considered by the Attorney General in a sense applicable to the case at bar.

However, after the effective date of the Twenty-first Amendment to the Constitution, and the repeal of the National Prohibition Act, December 5, 1933, the taxation and control of distilled spirits imported from foreign countries and the island possessions became a problem. By the Liquor Tax Administration Act, Section 329 (c), *supra,* Congress made Title III of the National Prohibition Act and the provisions of internal revenue laws relating to enforcement applicable in the Virgin Islands. This indicated clearly that the taxing of products of the Virgin Islands was intended to be assimilated to the domestic situation. Within a short period thereafter the Commissioner promulgated Treasury Decision 4770, approved October 25, 1937,

supra. Since under the circumstances it made slight practical difference whether or not the Treasury asserted the authority to collect any tax, there would be no reason for Congress to take any action in the matter. Accordingly there is no basis for spelling out a legislative confirmation of the applicability of any particular statute. It is clear that in the enactment of the Internal Revenue Code in Section 2800 (a) (4) (B), Congress made Section 3350 the applicable statute.

The cases cited by the taxpayer in its brief are not applicable because here there is no ambiguity in the statute (Section 1304 of the Revenue Act of 1918, c. 18, 40 Stat. 1057), and this case should be governed by the language of the statute and not by any previous inaction of the Commissioner.

In *Sterling Cider Co. v. Hassett,* 133 F. (2d) 590 (C.C.A. 1st), the appellant contended that apple cider manufactured by it did not come within the definition of apple wine, as defined in the regulations. In answer to this contention, the Court said (p. 595): "We are governed, however, not by the regulations but by the language of the statute", and the fact that the Commissioner did not collect taxes on cider sold by the farmers was not controlling.

The rectifying tax of 30 cents per gallon was properly collected on the rum in question.

III.

THE BASIC DISTILLED SPIRITS TAX UNDER SECTION 600 OF THE REVENUE ACT OF 1918, AS AMENDED, AND SECTION 2800, INTERNAL REVENUE CODE, IS COLLECTIBLE ON THE WINE GALLONS WHEN BELOW PROOF, WHEN WITHDRAWN FROM BOND.

Section 2800 (a) (1) provides for the payment of the tax "on each proof gallon or wine gallon when below proof * * * to be paid by the distiller or importer when withdrawn from bond." Section 3350 (a) of the Internal Revenue Code provides that the tax shall be "levied, collected, and paid in the United States".

In the case at bar we must look to the articles as of the dates on which they were withdrawn from the customs bonded warehouse; that is, as to the kinds of spirits, the proof of the spirits and the rates of tax. At the time of withdrawal from the customs warehouse the spirits were 86 proof, and therefore taxable on the wine gallons. The withdrawal dates are set out in the "Appendix" attached to the complaint (R. 16-18), and are subsequent to the dates on which the rum was brought into the United States.

The taxpayer contends that the tax should be on the proof rather than wine gallons because the rum as originally distilled was more than 100 proof and later reduced below proof with distilled water, thus bringing the spirits within Sections 180.98, 180.133 and 180.134 of Regulations 24. (Appendix, *infra.*) Under these regulations, it was necessary for the importer to file the report of the gauge and a certificate as provided by Section 180.99. (Appendix, *infra.*)

These regulations were not promulgated until June 16, 1941, and prior thereto there was no procedure whereby the Commissioner could determine the gauge of spirits brought from the Virgin Islands other than at the port of entry. As to all rum brought into the United States before June 16, 1941, the tax on wine gallons was the only proper basis. As to the rum brought in after that date there had been no gauge made as required by the regulations, and no certificates were furnished as required by the regulations. The only proper basis for the tax, therefore, was the wine gallon rate.

If the regulation is valid it has the force and effect of law. *Maryland Casualty Co. v. United States,* 251 U.S. 342; *United States v. Smull,* 236 U.S. 405; *United v. Grimaud,* 220 U.S. 506.

In *Douglas v. Commissioner,* 134 F. (2d) 762 (C.C.A. 8th), it was held that since the regulation was valid, the allowance of the deduction was, therefore, subject to the condition prescribed by the regulation.

In *Spencer, Kellog & Sons v. United States,* 13 Ct. Cust. App. 612, it was held that (p. 616):

> * * * the regulations requiring notice of intent to export are mandatory and compliance therewith is a condition precedent to the right of the appellant to recover under the drawback provisions. Such regulations may not be disregarded and proof of exportation made in some other manner than that required by them.

In *Nestle's Food Co. v. United States,* 16 Ct. Cust. App. 451, the Court cites the *Spencer* case, *supra,* with approval and holds that compliance with the

regulations is a condition precedent to the right of the plaintiff to recover under the drawback provisions. See also *Powell v. United States,* 135 Fed. 881 (C.C. W.D.N.Y.); *Commissioner v. Krein Chain Co.,* 72 F. (2d) 424 (C.C.A. 6th).

Distilled spirits of domestic manufacture are produced at over 100 proof, but if they are below proof when withdrawn from bond the tax is payable on the wine gallons as provided by Treasury Regulations 26 (Code of Federal Regulations, 1940 Supp., Title 26):

> Sec. 186.115. *Spirits below proof.* When spirits are below proof the tax is levied on each wine gallon or fractional part thereof. For example: In case of a package of spirits, when the loss is not excessive, if the contents are found to be 44.55 wine gallons, 44.11 proof gallons the tax will be computed on 44.5 gallons.

In *United States v. Rathjen Bros., supra,* rum was imported into the United States from Cuba on May 11, 1938, and was withdrawn from the warehouse on July 6 and July 14, 1938. Under the Liquor Taxing Act of 1934, c. 1, 46 Stat. 313, the tax was $2, and under Section 710 of the Revenue Act of 1938, c. 289, 52 Stat. 447, effective July 1, 1938, the tax was increased to $2.25. In determining the amount of tax payable on the rum, the Court said (p. 104):

> It is clear that on July 6 and July 14, 1938, the dates upon which the involved merchandise was withdrawn from warehouse, the revenue laws provided that *all distilled spirits* produced in or imported into the United States *when withdrawn from warehouse* were subject to a tax of $2.25 per proof gallon. (Italics supplied.)

It would seem clear that the date on which the articles are withdrawn from the warehouse governs. At the time the rum, involved in this suit, was withdrawn from the warehouse it was 86 proof, and being below proof it was taxable on the wine gallons at the rates collected thereon.

The taxes on the rum were payable upon the quantity of distilled spirits imported whether placed in a customs warehouse or not. *Louisville Public Warehouse Co. v. Collector of Customs,* 49 Fed. 561 (C.C.A. 6th). In the instant case the quantity of rum did not change between the dates of importation and the dates of removal from the customs warehouse. The amount of the tax as to the number of gallons of spirits imported was not affected by the fact that the rum was placed in a customs warehouse. If the rum had not been warehoused the rate of tax which was in effect on the day the rum was imported would be the rate payable.

However, it appears that the last three items under Warehouse entry 964, December 5, 1938 (R. 16), and all items, except the first five under Warehouse entry 4623, June 3, 1940 (R. 16), were imported or brought into the United States prior to June 30, 1940, and were withdrawn from the bonded warehouse after June 30, 1940. The rate of tax through June 30, 1940, was $2.25 on each proof gallon or wine gallon when below proof, and subsequent to June 30, 1940, the rate of tax was $3 on each proof gallon or wine gallon when below proof, as provided by Section 213 of the Revenue Act of 1940, c. 419, 54 Stat. 516. The Commissioner collected $3 per wine gallon as provided by the Reve-

nue Act of 1940. That was the rate of tax which was in effect at the time the rum was withdrawn from the warehouse. It is respectfully submitted that the rate of tax which was in effect at the time the rum was withdrawn was the controlling rate rather than the rate when the rum arrived in the United States.

There should be no question about the correctness of this interpretation by the Commissioner, because the Revenue Act of 1940 provided for a floor tax of seventy-five cents on all distilled spirits on which $2.25 had been paid. Therefore, if $2.25 had previously been paid on the rum in question an additional seventy-five cents per gallon would have been payable thereon.

The taxpayer's argument that the rum should have been taxed at the proof gallon rate is based on the theory that all distilled spirits of domestic manufacture are taxed on the proof gallon; such, however, is not the case. Spirits which are placed in a bonded warehouse presumably at 100 proof are not taxed until such spirits are removed from bond. Immediately prior to removal, or upon removal, the spirits are regauged, at which time the wine gallons, together with the proof content, are determined. If the proof of the spirits is below 100, the tax is collected on the wine gallons. The fact that the spirits were originally manufactured at over 100 proof is not a factor to be considered.

The tax is levied upon the product and not upon the process; therefore, the process by which the imported rum was manufactured is not a factor to be considered in this case. In *Louisville Public Warehouse Co. v. Collector of Customs, supra,* the conten-

tion was made that the tax should be on proof gallons and not on wine gallons, but the Court held the assessment on the wine gallons to be proper. In that case the spirits were manufactured in the United States, exported and reimported into the United States.

It is respectfully submitted that the basic distilled spirits tax was payable on the wine gallons.

CONCLUSION.

The formulae alleged in the complaint show that the rums were rectified products and the alleged taxes collected by the Commissioner were those provided by law. The complaint, therefore, shows upon its face that the taxpayer is not entitled to refund. The decision of the Court below should be affirmed.

Dated, March 4, 1946.

Respectfully submitted,

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(Appendix Follows.)

Appendix.

Internal Revenue Code:

Sec. 2800. TAX.

(a) *Rate.*

(1) *Distilled Spirits Generally.*—There shall be levied and collected on all distilled spirits (except brandy) in bond or produced in or imported into the United States as internal revenue tax at the rate of $2.25 (and on brandy at the rate of $2.00) on each proof gallon or wine gallon when below proof and a proportionate tax at a like rate on all fractional parts of such proof or wine gallon, to be paid by the distiller or importer when withdrawn from bond.

(2) *Products of Distillation Containing Distilled Spirits.*—All products of distillation, by whatever name known, which contain distilled spirits or alcohol, on which the tax imposed by law has not been paid, shall be considered and taxed as distilled spirits.

(3) *Imported Perfumes Containing Distilled Spirits.*—There shall be levied and collected upon all perfumes imported into the United States containing distilled spirits, a tax of $2.25 per wine gallon, and a proportionate tax at a like rate on all fractional parts of such wine gallon. Such tax shall be collected by the collector of customs and deposited as internal revenue collections, under such rules and regulations as the Commissioner, with the approval of the Secretary, may prescribe.

(4) *Alcoholic Compounds from Puerto Rico, Virgin Islands and Philippines.*—

(A) *Puerto Rico.*—Except as provided in section 3123, upon bay rum, or any article containing alcohol, brought from Puerto Rico into the United States for consumption or sale there shall be paid a tax on the spirits contained therein at the rate imposed on distilled spirits produced in the United States, to be collected at the port of entry by the collector of internal revenue of the district in which the port is located. The Commissioner, with the approval of the Secretary, is authorized to make such rules and regulations as may be necessary to carry this paragraph into effect.

(B) *Virgin Islands and Philippines.*—For provisions relating to tax on alcoholic compounds from Virgin Islands and Philippines, see sections 3350 and 3340.

(5) *Rectified Spirits and Wines.*—In addition to the tax imposed by this chapter on distilled spirits and wines, there shall be levied, assessed, collected, and paid, a tax of 30 cents on each proof gallon and a proportionate tax at a like rate on all fractional parts of such proof gallon on all distilled spirits or wines rectified, purified, or refined in such manner, and on all mixtures produced in such manner, that the person so rectifying, purifying, refining, or mixing the same is a rectifier within the meaning of section 3254 (g): *Provided.* That this tax shall not apply to gin produced by the redistillation of a pure spirit over juniper berries and other aromatics. * * *

(26 U.S.C. 1940 ed., Sec. 2800.)

Sec. 2801. Rectified Spirits.

(a) *Rate of Tax.*—

For rate of tax, see section 2800 (a) (5).

(b) *Proof and Volume.*—When the process of rectification is completed and the taxes prescribed by section 2800 (a) (5) have been paid, it shall be unlawful for the rectifier or other dealer to reduce in proof or increase in volume such spirits or wine by the addition of water or other substance; nothing herein contained shall, however, prevent a rectifier from using again in the process of rectification spirits already rectified and upon which the taxes have theretofore been paid.

(c) *Exemption From Tax.*—

(1) *Cordials and Liqueurs.*—The taxes imposed by section 2800 (a) (5) shall not attach to cordials or liqueurs on which a tax is imposed and paid under paragraph (1) or (2) of section 3030 (a), nor to the mixing and blending of wines, where such blending is for the sole purpose of perfecting such wines according to commercial standards, nor to blends made exclusively of two or more pure straight whiskies aged in wood for a period not less than four years and without the addition of coloring or flavoring matter or any other substance than pure water and if not reduced below ninety proof; nor to blends made exclusively of two or more pure fruit brandies distilled from the same kind of fruit, aged in wood for a period not less than two years and without the addition of coloring or flavoring matter or any other substance than pure water

1940, c. 737, 54 Stat. 974, and to $4 by Section 533 of the Revenue Act of 1941, c. 412, 55 Stat. 687.

Revenue Act of 1918, c. 18, 40 Stat. 1057:

> Sec. 601. That no distilled spirits produced after October 3, 1917, shall be imported into the United States from any foreign country, or from the Virgin Islands (unless produced from products the growth of such islands, and not then into any State or Territory or District of the United States in which the manufacture or sale of intoxicating liquor is prohibited), or from Porto Rico, or the Philippine Islands. Under such rules, regulations, and bonds as the Secretary may prescribe, the provisions of this section shall not apply to distilled spirits imported for other than (1) beverage purposes or (2) use in the manufacture or production of any article used or intended for use as a beverage.

Act of March 3, 1917, c. 171, 39 Stat. 1132:

> Sec. 3. That on and after the passage of this Act there shall be levied, collected, and paid upon all articles coming into the United States or its possessions, from the West Indian Islands ceded to the United States by Denmark [Virgin Islands], the rates of duty and internal-revenue taxes which are required to be levied, collected, and paid upon like articles imported from foreign countries: *Provided.* That all articles, the growth or product of, or manufactured in such islands from materials the growth or product of such islands or of the United States or of both, or which do not contain foreign materials to the value of more than twenty per centum of their total value, upon which no drawback of customs

duties has been allowed therein, coming into the United States from such islands shall hereafter be admitted free of duty.

(48 U.S.C. 1940 ed., Sec. 1394.)

Liquor Tax Administration Act, c. 830, 49 Stat. 1939:

Sec. 329:

* * * * * * *

(c) Title III of the National Prohibition Act, as amended, and all provisions of the internal revenue laws relating to the enforcement thereof, are hereby extended to and made applicable to Peurto Rico and the Virgin Islands, from and after August 27, 1935. The respective Insular Governments shall advance to the Treasury of the United States such funds as may be required from time to time by the Secretary of the Treasury for the purpose of defraying all expenses incurred by the Treasury Department in connection with the enforcement in Puerto Rico and the Virgin Islands of the said Title III and regulations promulgated thereunder. The funds so advanced shall be deposited in a separate trust fund in the Treasury of the United States and shall be available to the Treasury Department for the purposes of this subsection.

Treasury Regulations 24 (1941 ed.):

Sec. 180.98. *Regauge.*—Distilled spirits withdrawn from insular bonded warehouses for bottling without rectification or for rectification and bottling and shipment to the United States may be gauged at the time of withdrawal by an insular gauger. A report of gauge shall be prepared

by the insular gauger showing the name of the distiller, the serial number, the proof of the spirits, and the wine and proof gallon contents of each package gauged. The report of gauge shall be attached to the certificate prescribed in section 180.99.

Sec. 180.99. *Certificate.*—Every person bringing liquors or articles under these regulations into the United States from the Virgin Islands, except tourists, shall obtain a certificate in the English language from the manufacturer for each shipment showing (1) the name and address of the consignee; (2) the kind and brand name; (3) the quantity thereof as follows:

(a) If distilled spirits, the wine and proof gallons.

(b) If fermented liquors, the gallons, liquid measure, and the per centum of alcohol by volume.

(c) If articles, the kind, quantity and proof of the liquors used therein.

(4) the number and date of the approved formula; (5) a declaration that it has been manufactured in accordance with the formula; (6) the name and address of the person filing such formula, and (7) a certification by the insular gauger that the spirits covered by such certificate were or were not regauged by him when withdrawn from the insular bonded warehouse and, if regauged, were at that time at the proofs indicated on the attached report of gauge. The consignee shall file the certificate and report of gauge with the collector of customs at the port of entry, as provided in section 180.133.

Sec. 180.133. *Conditions.*—The importer shall file the report of gauge provided for in section 180.98 and the certificate provided for in section 180.99 with the collector of customs at the port of entry in the United States.

Sec. 180.134. *Action by collector of customs.*—The collector of customs will direct the proper customs gauger to determine the taxable quantity of liquors contained in the consignment by regauge or inspection and report the result thereof to the collector of customs. Upon receipt of such report the collector of customs will refer to the approved formula covering the product to determine the rate of internal revenue tax applicable thereto. When the rate of tax applicable to the product has been ascertained, the tax due on the consignment will be determined in the following manner:

(a) *Distilled spirits.*—If the certificate is accompanied by a report of gauge made by an insular gauger and bears the insular gauger's certification, as prescribed in section 180.99, showing that the spirits covered thereby were 100 degrees or more in proof at the time of withdrawal from the insular bonded warehouse, the internal revenue tax at the distilled spirits rate will be collected on the proof-gallon contents of the packages, or cases, regardless of the proof of the spirits at the time of their entry into the United States. If the certification of the insular gauger and the accompanying report of gauge show that the spirits were less than 100 degrees in proof at the time of withdrawal thereof from the insular bonded warehouse, the internal revenue tax at the distilled spirits rate will be collected on the wine-gallon contents of the

packages or cases as determined by the customs gauger. If the certificate does not bear the certification of the insular gauger and is not accompanied by a report of gauge made by an insular gauger showing the proof of the spirits at the time of their withdrawal from the insular bonded warehouse, the proof of the spirits at the time of regauge or inspection at the port of entry in the United States will be the basis for determining the internal revenue tax due thereon, i.e., if the spirits are less than 100 degrees in proof, the distilled spirits tax will be collected on the wine gallons, whereas if the spirits are 100 degrees or more in proof, the distilled spirits tax will be collected on the proof gallons. The rectification tax on taxable rectified spirits will be collected on the proof gallons contained in the consignment regardless of the proof of the spirits at the time of their withdrawal from the insular bonded warehouse or at the time of their entry into the United States.

(b) *Fermented liquor.*—(1) *Beer.*—If the certificate covers beer, the fermented malt liquor tax will be collected on the basis of the number of barrels of 31 gallons each, or fractional parts thereof, contained in the shipment.

(2) *Wine.*—If the certificate covers wine, the wine tax will be collected at the rates imposed by section 3030, Internal Revenue Code, as amended.

(c) Articles.—Where articles contain liquors, the tax will be collected at the rates prescribed by law on the liquor contained therein as shown by the certificate. (* * *; Secs. 2800(a)(1), 2800(a) (4) (A), 2800 (a)(5), 3030, 3150(a), I.R.C.)

Treasury Regulations 26 (Code of Federal Regulations, 1940 Supp., Title 26):

Sec. 186.115. *Spirits below proof.* When spirits are below proof the tax is levied on each wine gallon or fractional part thereof. For example: In case of a package of spirits, when the loss is not excessive, if the contents are found to be 44.55 wine gallons, 44.11 proof gallons, the tax will be computed on 44.5 gallons.

T. D. 4770, 1937-2 Cum. Bull. 568:

The Liquor Taxing Act of 1934, approved January 11, 1934 (U.S.C., 1934 ed., Title 26, sections 1150 *et seq.,* 1300 *et seq.,* and 1330 et seq.), as amended by the Liquor Tax Administration Act of June 26, 1936 (U.S.C., 1934 ed., Supp. II, Title 26, sec. 1300 (a) (1) and (2)), imposed taxes at various rates upon distilled spirits, wines, liqueurs and cordials, and fermented malt liquors. Rectification tax on rectified distilled spirits or wines at the rate of 30 cents per proof gallon is also collectible because of the provisions of the Third subsection of section 3244, Revised Statutes, as amended (U.S.C., 1934 ed., Title 26, sec. 1398 (f)), and the provisions of section 605 of the Revenue Act of 1918, as amended (U.S.C., 1934 ed., Title 26, sec. 1150 (a) (6)), if the product so rectified would be subject to that tax if manufactured in the United States.